Financial Accounting Support for Project Cost Control

An interesting Email exchange

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Introduction

It would be nice to think that corporate Financial Accounting, of it self, could provide "accounting" support for the projects that fall under their wing. Indeed, many project managers expect them to and do rely on Financial Accounting statements. Unfortunately, the kind of data kept in corporate Financial Accounting records is not the kind of data that is required by the project manager, nor is it usually sufficiently timely. Interestingly, certain types of data that corporate Financial Accounting needs to have is not available from the typical Project Cost Accounting system either.

These points are illustrated in the following Email exchange.

What can Financial Accounting do for projects?

After searching this web site for information on project cost accounting, Anibal Miranda sent us this Email on 6/28/12:

> "Max- I have been reading the articles [on your web site], which are very interesting, namely in the area of Project Cost Accounting. I would like to know whether you have produce some documentation around best practices and what support Financial Accounting can give to the project cost accountant in a big organization? There are items such as accruals, management information reporting and transfer pricing, which are standardized across businesses, budget holders and project managers.
>
> However, this is not enough so I am looking to have something that gives me the roadmap to excellence in terms of project cost control and accounting in liaison with financial accounting. Any help, or paper you might have written, will be great. I might buy some documents if they are relevant to my question.
>
> Many thanks, Anibal"

Our response

After some thought, we replied:

> "Hi Anibal, Thank you for your Email.
>
> I am afraid that I cannot be very helpful here. Almost all the documentation that I have of my own is already published on my web site, and to this point I have not come across any books devoted to the best practices you have in mind.
>
> However, I can offer some comments based on my experience. First off, I don't believe in "best practices" — I think that is just a catchy phrase invented by consultants to beguile unsuspecting clients. That's because as soon as you find a "best practice" someone will come out with a better one!

More important is to find solutions that best fit your own organization.

There have been many attempts to meld Financial Accounting systems with Project Accounting systems and some have claimed to work. However, I have never come across any that do. And the reasons are several, largely because the objectives, timeframes, reporting objectives and level of details are all different. For example, Financial Accounting systems are designed to record actual historical costs to the nearest penny. For project work, you are much more interested in future forecast costs, including as yet unspent commitments, estimated to the nearest 1%.

It's a case of apples and oranges.

Obviously, I do not know your particular circumstances, but frankly, I think you would be best off to obtain an independent system that serves your particular requirements and reconcile these records periodically with your financial accounting records. Bear in mind also that the requirements that I just mentioned would vary according to whether you are accounting at the project level, the program level or at a project portfolio level. The requirements for each of these three are not the same.

One final thought, when the Financial Accounting department is under pressure, such as at year-end or during budget formulation, their priorities are such that you can expect next to no service so far as Project Accounting is concerned. That means that without an independent system, you are left hanging out to dry.

Hope that helps,

R. Max Wideman, Vancouver, BC, Canada"

Anibal has a related question

" Thanks Max,

Just one more specific question that will help me to articulate the issue I have.

The way we work here is that we are a standardized central finance team and one of the functions is to support Project Managers, to adhere to the group finance policies and processes.

The PM has been made accountable for accruals in their project portfolio. Recently, the finance team has performed an exercise to evaluate the accuracy of those accruals against invoices paid, and the results were astonishing. You mentioned that accruals should not be part of a project accounting process. So I would like to understand why? And if you can perhaps give me an example to understand and link it to our results.

Thanks.

Regards,

Anibal"

To this we responded

> "Hello again Anibal, we are getting into deep water here — as they say: "The devil is in the details".
>
> I don't think I said anything about "accruals" per se. By "accruals" I assume that you mean: "money added as a result of periodic growth"? If that is true, then I don't expect a project or project portfolio to have any significant return on investment until completed — it is all on the expense side. It is true that as projects progress they are on their way to an ROI [Return on Investment], but the ROI is notional at that point and any assumptions made in that respect seem to me to be very dangerous, perhaps even misleading.
>
> However, if by "accruals" you are referring to the amount of a commitment actually consumed to a given date, but not yet invoiced, or possibly invoiced but not yet approved, or even invoiced and approved but not yet paid (i.e. check cashed) then that indeed should be included in the project's cost status as of a given date report. And by the same token, the balance of that commitment plus all other now expected expenditures to complete the project should be included in the project's estimated "forecast-to-complete".
>
> The problem with all of this is that the cost-to-date, e.g. how far along we are with the consumption of a commitment is an estimate, and how much is in the future cost is also an estimate. So without a detailed analysis the best we have is a best guess, and by tomorrow the figures will be different anyway. In other words, the value of the answer is questionable. Besides, the primary responsibility of the project manager is to get the job done, not fiddle with finances.
>
> Yet, for a large commitment, like the delivery of a piece of equipment, the sudden appearance of the payment for the item on the ledgers can be a shock for accountants responsible for managing cash flow.
>
> Which is why I advocate for a separate project management accounting system that is designed for the type of project under review and that deals with issues such as I have described. And in particular recognizes that estimates are a necessary part of such a system, and that estimating is not an exact science and should be applied only where necessary with practical common sense."

As a point of interest regarding ROI, Figure 1 shows a typical cash flow for a project and its product life span. Note that during the project, the cash flow is all on the expense side. Note also the effect of the quality of project management on the ultimate earning power of the product. That is, skimpy project management may result in a cheaper product, but the product's return may risk a substantially shortfall in the long run.

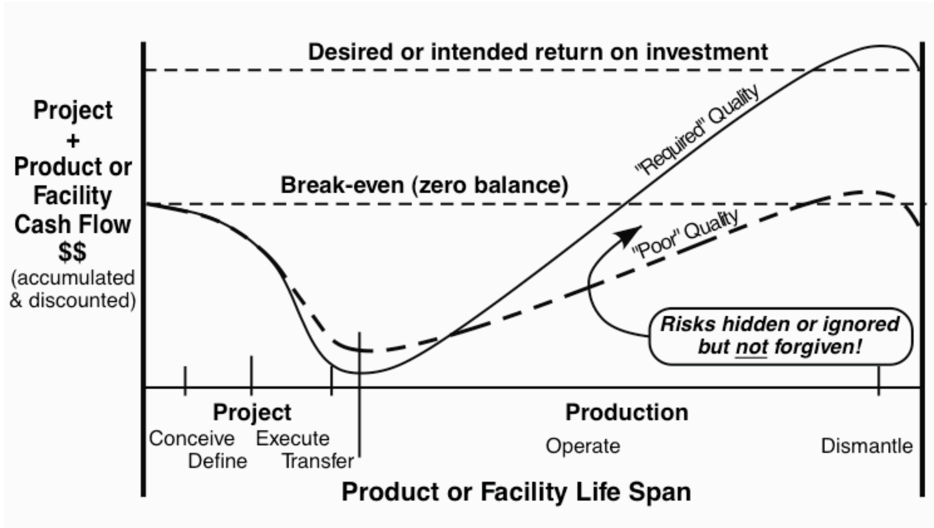

Figure 1: Project/product cash flow over the entire life span[1]

Summary of issues

Of course the corporation's set of Financial Budgeting and Accounts will obviously have one or more line items covering the money set aside for, or spent on, each approved project, or perhaps groups of projects. And as I write this up many months later, I do recall being asked to reconcile my project's Cost Control Accounting records with the corporate Financial Accounting records. While we could get close by analysis we were never able to reach exact agreement, partly because of the difficulty of reconciling the respective cut-off dates.

The reasons for the difference were several:

- The Financial Accounts lumped together several smaller projects under one-line entries.
- At any given time, we always had larger projects "in-progress", the positions of which we had to estimate. This was especially the case where subcontractors were involved and their sub-trade progress invoices had either not yet been submitted; or had been submitted but not yet reviewed and approved.
- The Financial Accounts opened a new record at the start of each financial year, whereas the project cost accounts accounted by individual project, some of which spanned across financial year-end boundaries.
- At the end of the year, the Financial Department distributed corporate overheads across all accounts. The amount depended on the corporate revenue and expenditures during the year including that spent on projects. In poor economic times the distribution was higher than in good years. We never knew what that amount was or would be and how it was arrived at.
- At times, some of our projects were charged with unbudgeted corporate services such as legal services, or staff recruiting costs, over which the project manager had no control.
- In house work was charged at some internal average "cost of labor" rate based on time sheets or weekly reports. We suspected that some projects were seen as "happy hunting grounds" for undocumented effort.

Recommendations:

- Keep the individual project cost control accounting on a project-by-project basis.
- Keep it separate from the corporate central Financial Accounting records.
- Establish clear practices connected with overhead distribution, including corporate services.
- Establish hourly rates for in-house time allocation.
- Make sure that in-house time-to-projects is collected on a reasonably reliable basis.

Second thoughts

Looking back over Anibal's last Email, we see that we may have missed an important point. Anibal said:

> "The way we work here is that we are a standardized central finance team and one of the functions is to support Project Managers, to adhere to the group finance policies and processes."

Perhaps Anibal is referring to a responsibility imposed on the corporate central finance team to get Project Managers to adhere to a set of ***common*** finance policies and processes. In other words, common procedures across all active projects that will enable effective and comparative reporting across a whole set of projects, i.e. one or more project portfolios. If this is the case, then this is an issue of establishing a common project governance structure that enables realistic and comparative reporting over a variety of projects.

A common project governance structure means that corporate management imposes a common set of control gates, or stage gates, over the life span of every project from initiation to product delivery. This set of gates is imposed to an extent that satisfies the control needs of the organization. These gates should be relatively limited and represent major milestones common to the majority of projects, and beyond which each project enters a new phase with significant new expenditures.

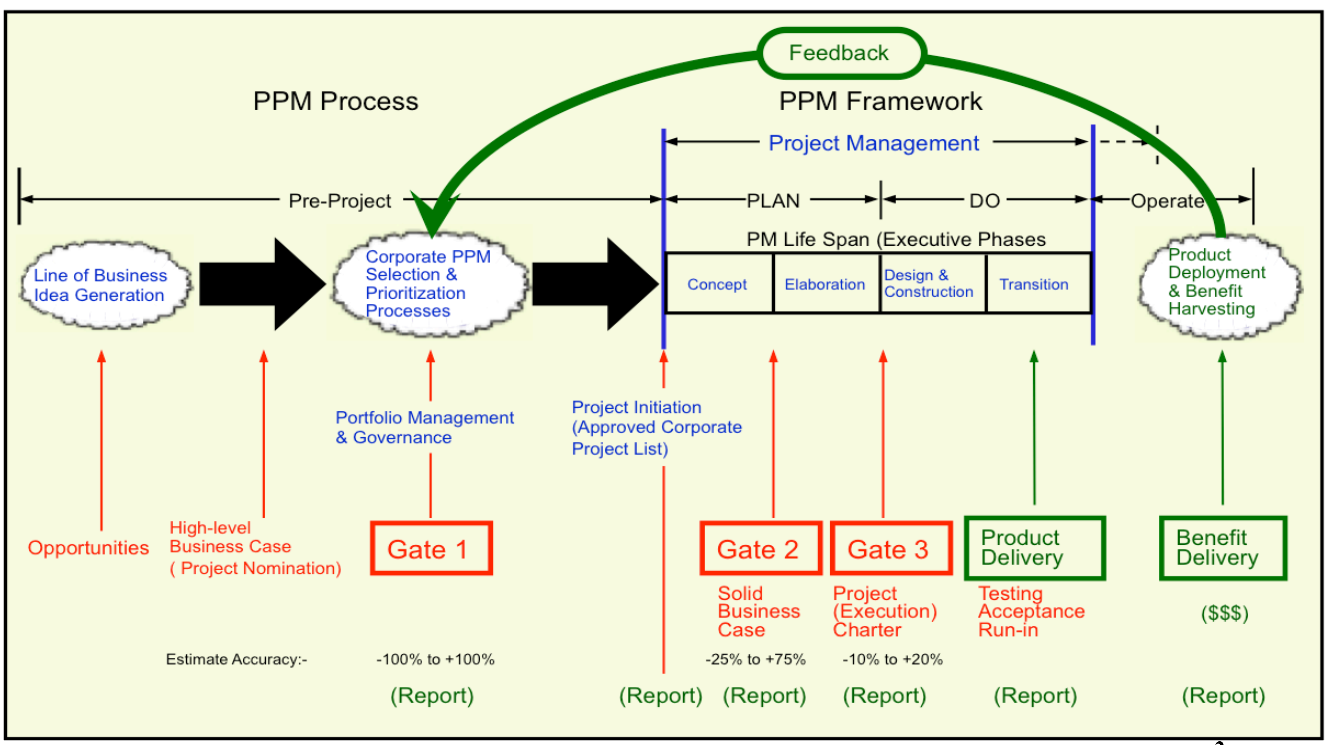

Figure2: Project portfolio management control over the project-product life cycle[2]

In short, we are now talking about project portfolio management as distinct from individual project management – a whole different level of management above the project manager.

We hope all of that helps.

Max Wideman

Footnote and References

Earlier in the Email exchange, we did indicate that we had "not come across any books devoted" to the "support Financial Accounting can give to the project cost accountant". There are, however, many excellent books devoted to corporate accounting. Just go and Google "Management Accounting" to get a large number of results to choose from.

Similarly, there are a number of books available on Project Cost Accounting. One of the first is my own book: *Cost Control of Capital Projects*[3] originally published in 1995. Or you can find a list of references on my web site here: http://www.maxwideman.com/sitemap/cost.htm

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[1] Reproduced with permission from *A Management Framework for Project, Program and Portfolio Integration*, by R. Max Wideman, Trafford, 2004, Figure 8-9, p114

[2] Reproduced from Issacon #1004c11 Page 7 [Link: http://www.maxwideman.com/issacons/iac1004c11/sld007.htm]

[3] Originally available from Bi Tech Publishers Ltd, 173-11860 Hammersmith Way, Richmond, BC, Canada, V7A 5G1, telephone: 604-277-4250.